

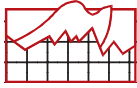
IBON POLICY PAPER
OCTOBER 2005

Regulation: An Urgent, Doable Response to High Oil Prices



IBON FOUNDATION INC.

3rd floor SCC Bldg., 4427 Int. Old Sta. Mesa, Manila · P.O. Box SM-447, Manila.
E-mail address: editors@ibon.org · Tel. Nos. 713 27 37, 713 27 29 and 713 09 12 · Fax 716 01 08



Regulation: An Urgent, Doable Response to High Oil Prices

The Arroyo government has been scrambling to come up with a credible program that will lessen the impact of high oil prices on the economy and the people's livelihood. Its main response is basically the much-publicized energy conservation program that fails to bring immediate relief for the public since the most urgent problem is the exorbitant price of oil. And besides, even prior to the oil price crisis, local consumption has already been decreasing while the importation cost continues to swell.

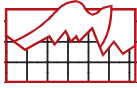
IBON Foundation, Inc. has been advocating for the repeal of Republic Act 8479 or the Downstream Oil Industry Deregulation Act of 1998 to allow the government to control and regulate the activities of the oil companies operating in the Philippines, particularly in terms of pricing. This paper further clarifies the various terms that an alternative policy to deregulation must contain to be truly effective. Our proposal includes seven basic provisions:

1. Centralized procurement of imported crude oil and refined petroleum products
2. Commodity swap and other non-traditional trade arrangement
3. Buffer fund to cushion the impact on consumers of sudden increase in oil price
4. Government buy back of Petron Corporation
5. Active State involvement in petroleum refining
6. Mechanism to ensure reasonable pump prices

7. Effective State control over the exploration, development, and utilization of domestic petroleum sources

Declaration of State Principle and Policy on Oil

The package of reforms that IBON is proposing hinges on the principle that crude oil and various petroleum products derived from it are crucial to the national security and industrialization of the Philippines. It is therefore imperative for the State to declare as a matter of national policy that all activities relating to the downstream and upstream oil industry including but not limited to the importation, exportation, re-exportation, shipping, transporting, refining, distributing, and marketing of crude oil and finished oil products as well as the exploration, development, and utilization of all domestic petroleum resources must under be the full



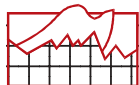
control and supervision of the State. All existing laws, executive orders, presidential decrees, and other government statutes that are inconsistent with such principle and policy must be repealed so as to allow the State to:

1. Ensure that the country has adequate and continuous supply of crude oil and refined petroleum products under the most economic and competitive terms possible considering all available sources of supply, including local supply.
2. Ensure that the entire petroleum industry serves the national interest and economic needs of the country.
3. Ensure that the consuming public enjoys reasonable prices of petroleum products and prevent price manipulation, unfair competition, and other trade abuses being committed primarily by big foreign oil corporations.
4. Promote Filipino capital, labor, and technology in the downstream and upstream oil industry.
5. Uphold the constitutional guarantee of full state control and supervision over the country's petroleum resources in the name of national interest and pursuit of industrialization, while maximizing whatever benefits that foreign financial and technical assistance will bring in the exploration, development, and utilization of local crude oil and other petroleum.

Centralized Procurement of Imported Petroleum

Almost 9 out of every 10 liters of oil sold in the Philippine market come from the Big Three (Caltex Philippines, Petron Corporation, and Pilipinas Shell), a group of companies that have their own oil fields abroad as well as their own global network of pipelines, tankers, depots, refineries, and retail stations. Such commanding position has allowed Shell, Caltex, and Petron to impose exorbitant prices on the domestic oil market. Deregulation, or the lack of substantial government intervention in the oil industry, has given these companies more room to manipulate the price of petroleum at the expense of the consumers and the economy. A system of centralized procurement of imported crude oil and refined oil products is therefore necessary to ensure the steady supply of reasonably priced petroleum in the country.

Under centralized procurement, the Philippine National Oil Company (PNOC) becomes the sole importer of crude oil and refined petroleum products, which refiners and retailers operating in the country will have to purchase from. Consequently, PNOC must have substantial control over the country's oil storage facilities. There are around 119 oil depots nationwide, and PNOC can at first control the most strategic among these storage facilities such as the Subic Bay terminal (the largest in the country with a storage capacity of 3 million barrels), which at present is being operated by a joint venture of US-based Coastal Corporation and the Petroleum Authority of Thailand. At the same time, PNOC can also utilize Petron's storage facilities and lease privately owned depots to meet its storage requirements.



Since outright procurement of 100% of the national petroleum needs may be burdensome for the government, it can design a program that will spread over a certain number of years the proportion of its imports to the total requirements of the local market. The government will peg its importation volume on the actual import volume of the preceding year so it can properly allocate a budget for its oil procurement.

For example, under a five-year program, PNOC would import on the first year a volume that is equivalent to 20% of the country's total import volume in the previous year. By the second year of its program, PNOC would import 40% of the import volume in the preceding year and so forth until it reaches the 100% level by the fifth year. By the time PNOC is already procuring 100% of the previous year's volume, its imports may be higher or lower than the actual need of the country. Under this situation, the surplus imports will be stored as a buffer supply of PNOC in case of any shortage or extremely high global prices, while it will have to withdraw from the said buffer and/or increase its imports to bridge the gap between its imports and actual domestic need.

Based on the annual growth average in volume (-2%) and value (18%) of oil imports from 1998 to 2004, IBON estimated that by 2006, under a gradual centralized procurement program spread over a five-year period, the government would have to import 24.7 million barrels of oil worth US\$1.2 billion. By 2010, the volume would reach 113.9 million barrels (or 100 percent of the 2009's estimated total imports) worth around US\$11.2 billion. The cost is expected to be lower as government negotiates

for special terms and arrangements with potential suppliers. (See **Table 1**)

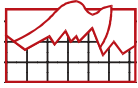
Table 1. Projected volume & value of oil imports

Year	Volume (MB)	Value (\$ million)
2006	24,721.41	1,252.87
2007	48,451.53	2,898.74
2008	71,220.17	5,030.09
2009	93,056.34	7,758.71
2010	113,988.28	11,219.53

IBON estimates based on DOE data

The government can use its earnings from Petron and the specific taxes imposed on petroleum products to partly finance PNOC's centralized procurement activity. From 1998 to 2003, collection from specific oil taxes averaged PhP24.9 billion while government's earnings from its 40%-equity in Petron averaged P820 million during the same period. Additional funds may also be sourced from royalties and taxes that the government earns from petroleum exploration and production, and government revenues from the corporate income tax being collected from the oil companies. In Malampaya alone, for instance, the government is expected to earn US\$400-500 million a year in royalties.

As an importer, the government does not have to impose a tariff or duty on its own oil imports even as it continues to charge such tax on private importers (i.e. prior to full centralized procurement). With the government as a major



(and eventually exclusive) importer of oil and a leading refiner and distributor (through a 100% State-owned Petron) at the same time, ordinary consumers as well as industrial users of petroleum will be assured of a more reasonable price of oil. This will also give the minor Filipino oil firms the leverage they need to be able to effectively vie for the local market against the transnational corporations (TNCs). Meanwhile, the country will be able to diversify its import sources considering that at present, two countries – Saudi Arabia and Iran – already account for more than 85% of total crude oil imports that endangers our oil supply security.

In addition, the government can utilize various means of procuring imported petroleum unlike the current system wherein the local units of TNCs are being supplied by their own mother units therefore making oil artificially expensive through transfer pricing (i.e. the practice of bloating the price of a product as it is being transferred from one unit to another unit of the same TNC until it reaches the end-consumer). PNOC, for instance, can bid out supply contracts to prospective exporters of crude oil and refined petroleum products, particularly to state-owned oil companies from oil-producing countries, to be able to purchase the cheapest petroleum. (See **Table 2**)

However, when looking for potential suppliers, the Philippine government must be cautious in dealing with these state-owned companies since some of them have strategic linkages with the oil TNCs and therefore collaborate with them. Saudi Aramco, which controls 40% of Petron, for instance, has refining and distribution arrangements with Royal Dutch Shell and Exxon Mobil. Priority must be given to

state-owned companies that oil TNCs have relatively less influence such as the PDVSA of Venezuela.

Another option is for the Philippine government to pursue a bilateral agreement with the national government of oil-producing countries. As an official pact between sovereign states, the Philippines can push for special terms in exchange for equally favorable concessions to the exporting country. One example that the national government must seriously study is the bilateral deal between Venezuela and Cuba where the former supplies the latter with 100,000 barrels a day of subsidized oil. In return, Venezuela receives medical help from more than 17,000 Cuban doctors and dentists stationed in Venezuela.

Commodity Swap

Another possible non-traditional trade arrangement to secure oil at a cheaper cost is commodity swap, which is a trade practice where parties involve swap products instead of buying each other's exports with foreign exchange. The Philippines can consider this scheme in order to minimize the impact of the fluctuations in the US dollar and peso exchange rate on the price of oil.

At present, of the 16 biggest crude oil exporters in the world, the Philippines sources its crude oil imports from seven countries but five of them only account for 14 percent while the rest come from Saudi Arabia (51%) and Iran (35%). On the other hand, the country exported a total value of US\$3.1 billion to 11 of these countries, but with Malaysia alone covering more than 80% of the amount. The country has no trade relations (for

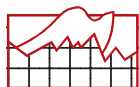
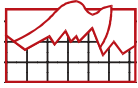


Table 2. World's biggest state-owned oil companies

Company	Country	Oil reserves (million bbl)	Production (1,000/day)
Saudi Aramco	Saudi Arabia	259,400	9,045
NIOC	Iran	125,800	3,582
INOC	Iraq	115,000	1,330
KPC	Kuwait	99,000	2,170
PDV	Venezuela	77,800	2,500
Adnoc	UAE	55,210	1,200
Libya NOC	Libya	22,680	896
NNPC	Nigeria	21,153	2,166
Pemex	Mexico	16,041	3,723
Lukoil	Russia	15,977	1,622
Gazprom /a	Russia	13,561	221
Petro China /a	China	10,997	2,120
Qatar Petroleum	Qatar	10,950	660
Sonatrach	Algeria	10,533	1,729
Petrobras /a	Brazil	9,772	1,701
Petronas	Malaysia	7,136	731
Pertamina	Indonesia	4,722	1,701
Eni /a	Italy	4,138	981
ONGC /a	India	3,711	557
Sinopec /a	China	3,257	742
PDO /a	Oman	3,193	702
Socar	Azerbaijan	3,105	178
Rosneft	Russia	2,400	393
Syrian Petroleum	Syria	1,886	317
EGPC	Egypt	1,800	375
Statoil /a	Norway	1,789	740
Ecopetrol	Colombia	1,542	292
Norsk Hydro /a	Norway	993	395

/a Less than 100% state ownership

Compiled by *IBON* based on Energy Intelligence Group data



petroleum or other commodities) with major crude oil exporting countries Algeria, Iraq, Libya, and Kazakhstan, which have a combined export capacity of 5.6 million barrels per day. (See Table 3)

The main imports of these countries include agriculture, food and consumer goods, which the Philippine government has already been promoting for exports. All this shows that the country has a lot of trade opportunities to explore if it would look for possible commodity swap partners. Aside from commodity swap, the government can also negotiate for a bilateral agreement wherein the country would purchase petroleum imports using the Philippine peso, which the oil exporting country can use in the future to pay for their imports from the Philippines. The Department of Trade and Industry (DTI) may be tasked to conduct studies on which petroleum exporting countries would such arrangements be most feasible.

Buffer Fund

Another important element of government regulation on the oil industry is the establishment of an oil price buffer fund, which is different from the Oil Price Stabilization Fund (OPSF) set up by the late strongman Ferdinand Marcos. The OPSF was not used as a buffer fund in the strictest sense of the word but merely served as a mechanism to protect the profits of the Big 3 during oil shocks.

Under the old set up, oil companies replenished the OPSF when their pump price was higher than world prices and withdrew from it when the opposite happened. To ensure that the OPSF did not dry up, government delayed rolling back

the pump price even if world prices fell. Thus, the burden of replenishing the OPSF and ensuring TNC profits during drastic increases in global prices was imposed on the consumers.

Unlike the OPSF, IBON's proposed buffer fund would be used exclusively to mitigate the impact of sudden increases in world prices and would be replenished by government earnings from its centralized procurement, refining, and retailing activities.

Unlike the OPSF, IBON's proposed buffer fund would be used exclusively to mitigate the impact of sudden increases in world prices and would be replenished by whatever savings the government will accumulate from its centralized procurement of oil. The buffer fund will also be supported by a buffer supply, which as mentioned earlier, would be raised and maintained by the government through the full centralized procurement system to protect the local market during exceptionally high global prices. During the transition to full centralized procurement, when government savings are minimal and raising the buffer supply is not yet possible, Congress should allocate a portion of the national budget for the buffer fund. If unutilized within the fiscal year, such amount shall be carried over to the succeeding year until such time that the PNOC is already implementing full centralized procurement and able to replenish the fund.

This system eliminates the concern that a buffer fund is not operable in an industry where there are too many players that include small, independent companies that might only take advantage of the government subsidy. What the government must subsidize through a buffer

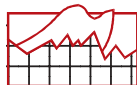
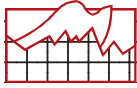


Table 3. Possible commodity swap partners

Country	Global oil exports ('000 barrels per day) /a	Share to RP crude oil imports /a	FOB value of total imports from RP (\$ million) /b	Main imports that the Philippines may Provide in exchange for petroleum
Saudi Arabia	8,730	50.78%	41.2	Food stuffs
Russia		6,670	0.82%	13.9 Consumer goods, meat grain, sugar
Norway	2,910	-	4.7	Food stuffs
Iran	2,550	34.36%	13.1	Food stuffs
Venezuela	2,360	-	1.6	Raw materials
UAE	2,330	0.72%	102.5	Food
Kuwait	2,200	-	15.3	Food, clothing
Nigeria	2,190	-	7.1	Manufactured goods, food, live animals
Mexico	1,800	-	110.8	-
Algeria	1,680	-	-	Food & beverages, consumer goods
Iraq	1,480	-	-	Food, manufactures
Libya	1,340	-	-	Food, manufactured goods
Kazakhstan	1,060	-	-	-
Qatar	1,020	7.60%	-	Food
Indonesia	489	0.38%	295.5	Food stuffs
Malaysia	230	4.64%	2,462.50	Food
/a 2004				
/b 2003				

Compiled by IBON based on data from EIA-US DOE, www.geographic.org, and www.mapquest.com



fund is the pump price of oil and not the profits of the oil companies.

The Department of Energy (DOE) in coordination with the Department of Finance (DOF) should manage the buffer fund. They must draw up a strict set of guidelines on when the government can tap into the fund so as to discourage its unwarranted utilization and exploitation by corrupt government officials. The DOE must compute a trigger price (i.e. based on the projected impact of an oil price hike on inflation) that will determine when the buffer fund should be used.

Reclaiming Petron

To further strengthen its position in the downstream oil industry, the government must also reverse the privatization of Petron. An effective state control over a company that accounts for one-third of the downstream market would allow the government to check the unscrupulous and capricious practice of private oil firms in implementing oil price hikes.

The government easily dismisses this option because of lack of state resources to reacquire the government's shares in the biggest oil company in the Philippines. But according to Representative Robert Barbers in a bill he filed last year, if the government were to buy back 11% (900,000 shares) of Petron, it will only need PhP2.4 million based on the selling price of Petron shares in the stock market as of August 2004. This amount could be easily covered by the earnings of the government from its current 40% stake in the company such as the estimated PhP1.2 billion it earned in 2003. In other words, the government can immediately

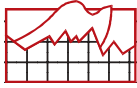
begin taking back Petron from Saudi Aramco without putting a strain on its already precarious fiscal situation.

But our proposal is not only for the national government to gain a majority share (i.e. 51%) in Petron. Although it can implement a gradual takeover, the ultimate objective should be full control of the company. Government's centralized procurement system will become less effective if it will not have a substantial participation in refining and distribution of petroleum products to the end-consumers because at present, 86% of the downstream market is under the domination of the TNCs (including Saudi Aramco-controlled Petron). Thus, even if government is the exclusive importer of petroleum, the TNCs will still have a considerable influence on the retail price of oil products if the government will not be involved down to the retail aspect of the industry.

The government should exhaust all legal/constitutional and diplomatic means to compel Saudi Aramco of the necessity of reversing the privatization of Petron.

Active State Involvement in Refining

Refining is another component of the downstream oil industry that the government must actively engage in to ensure a secured and affordable supply of petroleum products. Full state control over Petron is critical since it accounts for 180,000 of the 290,000-barrel per day refining capacity of the country (Shell controls the remaining 110,000).



But the country's current refining capacity could no longer keep up with the increasing demand and in the light of Shell's reported plan to stop its local refining operation, it has become even more necessary and urgent for the government to design a program that would increase the country's refining capacity to meet the domestic needs.

PNOC must take the lead in providing new investment for additional refining capacity. But to lessen the financial pressure on the state-owned company, Filipino firms must also be encouraged (and must be given priority over foreign investors) to pour investments in petroleum refining. To attract local investors, the government must guarantee them of a secured market under its centralized procurement system.

Active state involvement in petroleum refining would also make certain that domestic petroleum resources would be fully maximized. Under the present situation, the country could not utilize Malampaya oil and condensate because existing refineries, which are under the effective control of foreign companies, supposedly do not have the facility to process them. Apparently, it is not profitable for them to upgrade their refineries to suit local petroleum. However, in the face of escalating cost of oil in the world market, the issue is not simply commercial viability but national interest.

Ensuring Reasonable Prices at the Pump

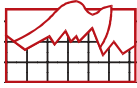
To further promote transparency and fairness in pricing, the DOE must require the oil companies to file for a petition every time they intend to

implement an oil price hike. The petition must justify the need to increase the pump price by detailing how the increase in the world market price impacts on the various components of their pump price. The DOE shall have the sole authority to grant or reject any petition for a price hike after exhaustive and democratic consultation with the public. The consultation process must ensure that the organizations of the different sectors most affected by the oil price hike including but not limited to the transport sector, consumer groups, and other people's organizations, as well as independent experts will be invited although the consultation is open to anyone who intends to participate. The details of the public consultation should be announced through newspapers of major circulation at least one week before the scheduled consultation.

Meanwhile, with PNOC's centralized procurement of petroleum and substantial state participation in refining, the government would be in a better position to ensure that the prices at the pump stations nationwide reflect the reasonable cost of oil. The energy, justice, and trade departments must form a joint task force, which will also mobilize independent consumer groups, that would regularly monitor the prices at all pump stations in the country to guarantee that retailers are not overpricing the public.

State Control over Local Petroleum Sources

Parallel to the efforts of the national government to regulate the downstream oil industry are the efforts to institute important reforms in the upstream level of the industry. Presently, the government is using the Service Contract



system, which was sanctioned by Presidential Decree 87 or the Oil Exploration and Development Act of 1972 under the Marcos administration. Under this arrangement, it is assumed that the government (through the DOE) retains ownership over the petroleum reserves of the country as required by the Constitution even as it hired the services of private and foreign contractors for the exploration, development, and utilization of such resources.

In spite of the constitutional guarantee on the full State control and supervision over domestic petroleum resources, the Service Contract system has in fact stripped the government of such right and obligation, at the expense of the national interest, as the Malampaya case clearly shows. It is therefore necessary for the legislature to repeal PD 87 and replace it with a system that would uphold the people's ownership over the country's resources and ensure effective State control, while maximizing foreign technical and financial assistance. Such alternative must guarantee that:

1. All petroleum extracted from the Philippine territory must not be exported until such petroleum has been fully utilized for domestic consumption.
2. The State will play the decisive role in determining what areas need to be developed for petroleum exploration and production, and that foreign companies will not be able to hold the country hostage to their interest.
3. There is equitable distribution of benefits from petroleum exploration and development projects. Net distribution (excluding taxes) should at least be 60% for the State and 40% for the companies based on the assumption that we own the resources that are being exploited and that the corporations will eventually recover their investment and reasonably profit.
4. There are no unnecessary perks that may undermine the benefits that the State will gain from the project, and that 100% profit and foreign exchange repatriation will be disallowed.
5. The rights and welfare of communities affected by exploration and development projects will be given due regard at all times

Postscript

All of these initiatives should form part of a long-term program that envisions a nationalized Philippine oil industry. Oil is too important a commodity that any government seriously pushing for industrialization cannot risk to completely put in the hands of profit-oriented TNCs that do not have a concept of national interest. To achieve this, a major overhaul of the national economic framework, which is too dependent on foreign technology and capital, must first be initiated. In the meantime, the executive and legislative branches of the government have the doable option to regulate the various aspects of the industry even as it allows the participation of foreign corporations. ■